DOW THEORY LETTERS INC.

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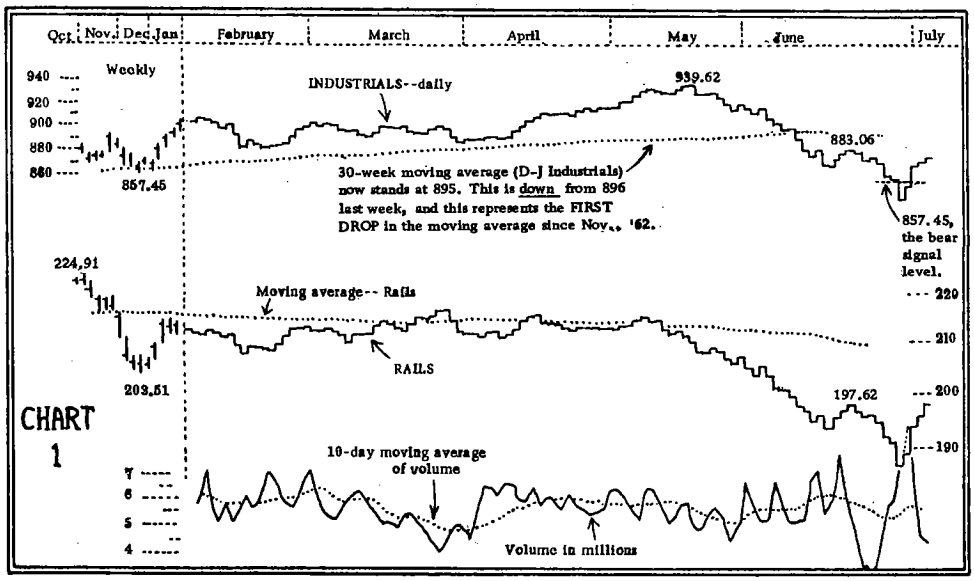
A BEAR MARKET: On June 25, 1965, the D-J Industrial Average closed below its December low of 857.45. By so doing, Industrials confirmed the previous penetration of the Rail Average. According to Dow Theory, a primary bear market has been signalled, and we now know that the bull market which began on June 25, 1962, ended on October 20, 1964 (when the two Averages recorded their last confirmed highs). The full meaning of the erratic, "out-of-gear" series of movements since October, 1964 has also been clarified; they represent the first part of a primary bear market.

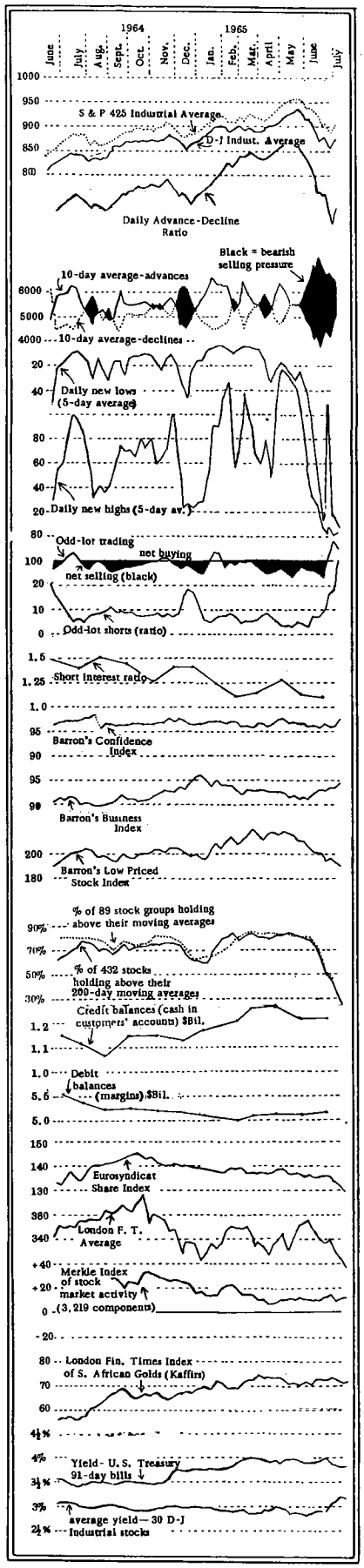
The argument is being voiced that a Dow Theory bear signal comes "too late." Unfortunately, I do not make the bear signals, I only call them as I see them. Others protest that there have been sundry "false" bear signals in the past. And it is true; there have been a few bear signals which did not produce substantial further losses, but this is as it should be. If a collapse was guaranteed after every bear signal and an upward "explosion" was certain after every bull signal, we would then possess the perfect device for beating the market. After a bear signal every investor and institution in the nation would "clean house," and the bear market would be over after one or two crushing days. Under such conditions, there would shortly be no market at all.

Still other investors and students note that "this" or "that" economic, social or political factor does not allow for a bear market at this time. But the Averages have already weighed all the evidence, and they have weighed it with more eyes and more intelligence and more insight than can be mustered by all the agencies of the Government working together with all the analysts in all the brokerage houses on Wall Street.

When a change in the primary trend is signalled, investors have to decide whether they wish to act on the probabilities or whether they want to count on "this particular signal being an exception." There are always exceptions, and, in fact, every bull and bear market produces some sort of exception of its own. Thus the 1929-32 bear market was exceptional in that it wiped out 89% of the value of Industrials, the 1938 bull market was exceptional in that it was so short in point of time, the 1939-42 bear market was exceptional because it lasted much longer than the preceding bull market, the 1946 bear market was exceptional because it was not followed by a severe recession, the bull market that started in 1949 was exceptional in that it was the longest bull market in history. The list could go on for pages. Nevertheless, the point is that the odds are in favor of historical probabilities repeating themselves.

Those of us who have had to operate in the market over a period of years have learned to avoid


Oct. Nov. Dec. Jan. February March April May June July
Weekly
INDUSTRIALS--daily
939.62
883.06
857.45
30-week moving average (D-J Industrials) now stands at 895. This is down from 896 last week, and this represents the FIRST DROP in the moving average since Nov., '62.
857.45, the bear signal level.
224.91
Moving average-- Rails
RAILS
203.51
197.62
10-day moving average of volume
Volume in millions
CHART 1


1964
1965
June July Aug. Sept. Oct. Nov. Dec. Jan. Feb. Mar. April May June July
S & P 425 Industrial Average
D-J Indust. Average
Daily Advance-Decline Ratio
Black = bearish selling pressure
10-day average-advances
10-day average-declines
Daily new lows (5-day average)
Daily new highs (5-day av.)
Odd-lot trading
net buying
net selling (black)
Odd-lot shorts (ratio)
Short interest ratio
Barron's Confidence Index
Barron's Business Index
Barron's Low Priced Stock Index
% of 89 stock groups holding above their moving averages
% of 432 stocks holding above their 200-day moving averages
Credit balances (cash in customers' accounts) $Bil.
Debit balances (margins) $Bil.
Eurosyndicat Share Index
London F. T. Average
Merkle Index of stock market activity (3,219 components)
London Fin. Times Index of S. African Golds (Kaffirs)
Yield - U.S. Treasury 91-day bills
average yield—30 D-J Industrial stocks

dogmatism and preconceived notions. But there are a few "rules" which I adhere to, and one of them is that I sell out before or on a bear signal, and I put my money on the line before or on a bull signal. These rules will not always work or prove profitable, but if you consistently violate them I can guarantee that you will "take a trip to the cleaners" before your investment career is over.

But what of the current bear market? What conditions could possibly produce another real collapse, a collapse which might justify selling stocks which have been held for years and purchased at perhaps a fraction of their present prices?

First, we do not know that a collapse is certain, but we do know that bear signals have been registered before all extended collapses of the past. The existence of a bear signal allows for the possibility of collapse, and it is from this logic that liquidation of securities before or on a bear signal is advocated. Secondly, it is a fact that most of the bad news during a bear market comes out after prices are well down (the converse is true, of course, during a bull market), and it is also true that few of us are wise enough to foresee the reasons for a primary movement in advance.

SAFETY: I am getting a flood of letters from new subscribers, and the question most often asked is: "What do I do with my money now that I have sold out?" My answer: purchase 91-day U. S. Treasury bills. These are the first (the shortest term) obligations of the U. S. Government. The bills must be paid off at maturity or the U. S. Government is in a state of bankruptcy. Behind the Treasury bills is the full taxing power (and assets) of the Government. If the bills cannot be paid off, the U. S. will go under and the dollar will not be worth any more than a comparable piece of paper. In other words, Treasury bills are tantamount to cash (although, of course, they have the advantage of yielding 3.8%, near their highest yield on record).

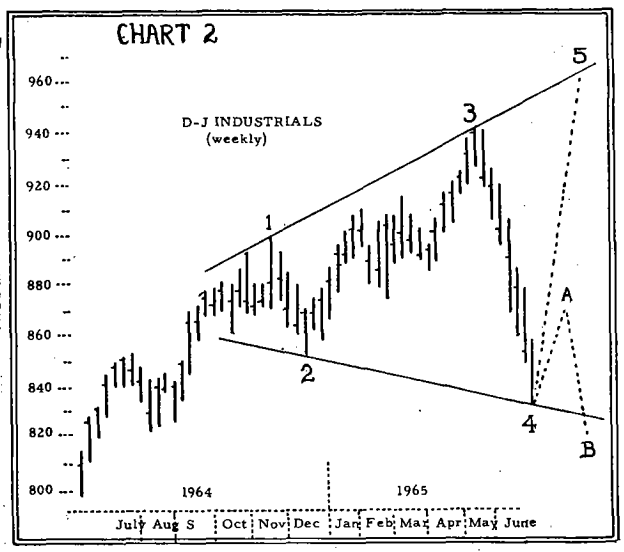
Treasury bills may be purchased through your bank or your broker (commissions are very nominal, but it is usually preferable to purchase bills in lots of $5,000). Orders may be given to the bank or broker to "roll over" the bills every 91 days (i.e., when they mature). Thus a standing "roll over" order means that you simply collect your interest every three months. Since Treasury bills are sold on a discounted basis, you collect your interest first (the interest is deducted from the face amount of the bills). Thus $10,000 of bills might cost you an immediate $9,940, and at the end of 91 days you receive your full $10,000 back.

Finally, the question is, where should you hold your bills? For the sake of argument, if the market suffers a devastating collapse over the next year it is conceivable that a few banks or brokerage houses will be in trouble. This could mean tying up assets, it could mean not being able to get your money out of the institution (since your money is considered an asset of the institution until you withdraw it). Therefore, we ask ourselves, why be 80% safe? Why not take full possession of the bills (and this goes for gold stock certificates as well). I now advocate that you have the bills sent to you (registered mail), and then place these bills in a lock-box in your bank. When the time for the "roll over" arrives, you will have to go to your box and turn the bills over to the bank again, and then have the new bills sent back to you. But this procedure is the safest that I know of. You will own an extremely safe security, and you will have personal possession of this security. As an aside, be prepared to receive a few sarcastic remarks from your broker or banker (they may even question your sanity). But there is a good answer. Ask your broker or your banker how he is doing in the market these days.

But since the possibility of real trouble is now widely questioned (indeed, many Wall Streeters and politicians are all but "guaranteeing" that this is no 1929 (and I purposely use 1929 because it represents such a wild extreme), let us examine a bit of contrary thinking. The following is from a recent column by famed economist Dr. Melchior Palyi of Chicago. I use this excerpt not as a prediction but merely as an "awakener." It is the type of thinking I would consider if I were a mind to "laugh off" last week's bear signal.

> "Let bygones be bygones, is a comfortable philosophy. However, an individual who fails to learn the lessons of his own experience, gets what he deserves. This holds for a nation as well. It is a poor excuse to argue that the circumstances change, which is true. There are constants which reassert themselves. They can be ignored at one's own peril only.
>
> "Speaking of circumstances: The six-year boom of the twenties rested on more solid foundations than the present one does. We were gaining gold then, losing now. The federal budget, which is tumbling now from one annual deficit into another, then produced a surplus year after year. The national debt was being reduced, not raised. Prices were stable; the "vicious spiral" and the "creeping" inflation" were unknown. And we enjoyed peace, real peace, with no cold war or little wars to darken the horizon. We were actually disarming, not just talking about disarmament, the fleet put largely into mothballs. There was no power on earth to fear or to fight. Taxes were moderate. No one in his right mind gave serious thought to the possibility that the dollar might be devalued. Business was unshackled, profit margins high. Technological and organizational progress was spectacular, and so was the progress of living standards.
>
> "It was a world of assured stability and unrelenting growth — an appearance that was misleading. Even the appearance of such real stability is absent today."

Question: In Letter 292 (pages 2 and 3) you wrote extensively regarding the potential "broadening structure" in the Industrial Average and a possible approach to the 939.62 May high again. Now that we have had a bear signal, do you completely dismiss the idea that the broadening pattern may be completed?
Answer: This market has shattered every precedent, both on the uncorrected 1962-65 advance and on the straight-line 1965 decline. I must admit that the following thoughts have been going through my mind this week. Could the market now commit the "crowning irony" by surging up towards the highs again — thereby scaring the shorts into mass covering as well as re-igniting the hopes of the bull? Then, upon approaching or even bettering the May Industrial high (unconfirmed by Rails or the A-D ratio), might not the whole structure then come crashing down on greater volume and with more violence than anything yet seen?



I have reprinted Chart 2 (from Letter 292), and it now includes the action of last week. This latest action allows for an even larger potential broadening top with the first four reversal points numbered 1, 2, 3 and 4 on the chart. An Industrial rise above 939.62 would set the stage for completion of the broadening pattern, and completion would, of course, entail a broad collapse following the final reversal point at 5.

A second possibility exists, and that is the A-B movement as shown by the dotted line on the chart. This would be the classic "head-and-shoulders" top, and I do not rule out this possibility either.

Conclusion: Many of us in the San Diego area (17 miles north of Tijuana, Mexico) have seen the brave bulls die at the weekly Corridas. The penetration by Industrials through the December low of 857.45 constituted, in my opinion, the "death thrust" for this bull market. But just as a great bull may struggle valiantly even while the blade is in his heart and even while his life blood is pouring out, so this market is thrashing about wildly in its agony. Veterans of the bull ring know that a dieing bull can be one of the most dangerous of beasts, and they treat him with utmost respect. I would advise readers to treat this bear market the same way. This means leaving it alone from here on. In its final convulsions, this market could turn and rend both the longs (which it has done) and the shorts (which it has done). The market is moving too fast, it is under too much compression, it is a floor traders affair from here on.

Question: Well, what action do you advocate now? Answer: (the following is addressed primarily to the record number of new subscribers who have come in over the past few months). I believe that the great post-war bull market is essentially over. Following whatever "summer rally" or retracement we may see in the period ahead, the bear market is going to get underway in earnest. In view of this, I have for many months been urging subscribers to "clean house." This means selling all equities, selling all long-term bonds and selling all assets which are being held for speculative purposes. This includes land, buildings, that business which you have been merely "thinking about selling," that interest in a local shopping center, etc. In other words, this may be the last chance to "clear the deck" for trouble ahead.

Question: What about short sales at the end of this rally and during rallies ahead? Answer: I have had a goodly amount of experience with subscribers and shorts, and my answer for the average subscriber is "no." Bear markets move too fast, bear rallies can be too vicious. The great Dow Theorist, Robert Rhea, a superb trader, wrote that about two-thirds of the losses he had sustained during his investment career were on the short side. My conclusion is that the average investor losses money in shorts. For this reason I advocated "discounted puts" in Letter 290 (extra copies of Letter 290 sent upon receipt of stamped, self-addressed envelope). Puts eliminate the psychological conditions which turn such a large majority of short sales into losses even during a major decline.

THE SOUTH AFRICAN GOLD shares are the only stocks which I have advocated holding in portfolios. Detailed discussions of the "Kaffirs" have appeared in previous Letters. These shares may be purchased through American Depository Receipts and if purchased from another U. S. citizen the Interest Equalization Tax is avoided. A tax of 7½% is withheld from dividends of non-residents of S. Africa, but U. S. holders may take a tax credit for amounts withheld. South African mines produce 70% of the Free World's gold; these shares represent the richest gold mines in the world. With international talk on the need for "more liquidity" and "monetary reform" now making the headlines (see feature article in the July 5 Newsweek), interest is again centering on the gold shares and the possibility of a multi-lateral agreement on a rise in the price of gold.

Subscribers (many of whom own assorted Kaffirs) complain that they cannot obtain information about their shares unless they subscribe to the (British) Mining Journal or some other professional publication. Following are a few briefs on recommended shares taken from late information received. Blyvoors earned 52¢ per share for the year ending June, 1964. Latest dividend payout is 33¢, meaning that this $4 issue yields about 8%. Life of mine estimated at 15 to 20 years. Free State Geduld, one of world's lowest cost producers, showed a 22% gain in net for year ending September 30, 1964. Dividends were recently raised to $1.96 with another dividend raise probably in the cards for 1965. This $19 stock now yields about 10%. Free State owns 50% of Freddies Consol. Mines, a mine which is expected to pay its first dividend at the end of this year.

President Brand's net rose 1.9% to $1.26 for the year ending September 30, 1964. The 88¢ dividend means that this $12 stock now yields about 7.5%. Western Deep Levels, destined to be the biggest gold mining operation in history (life expectancy 60 years) showed a net income increase of 13% in 1964 to 47¢ on the combined A and B shares. In the first quarter of 1965 this fabulous mine increased milled tons 24% and final net was up 51%. A dividend estimated at 37¢ on the A shares means that these shares (only the A pays a dividend now) yield about 3%. Purchase of all the above named shares is still recommended.

Subscribers should remember that I have not recommended a speculative position in the Kaffirs, but a "hedge" position of perhaps 10 to 15% of total assets. Thus a loss of say 20% in the price of the Kaffirs would mean a negligible loss in a portfolio hedged with 10% Kaffirs. But a rise in the price of gold and a rise of say 400% in the Kaffirs could mean a 40% gain in a portfolio which contained 10% Kaffirs.

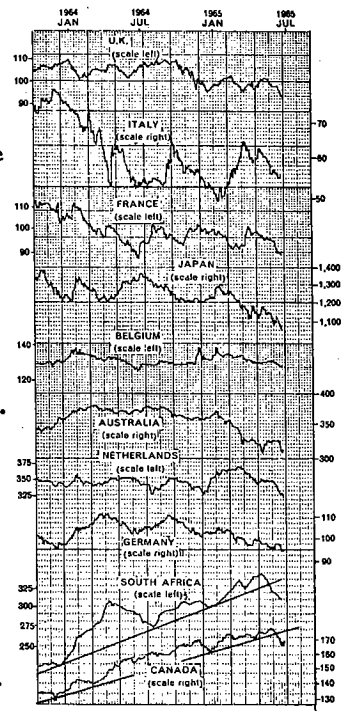
I urge subscribers to try to see the big picture which is that a bear market represents an extended period of falling values and declining prices. During a bear market the purchasing power of cash is increasing. Thus the investor who holds cash is literally speculating on the rising purchasing power of his cash assets. Just as a good portfolio of stocks represents a speculation in harmony with the bull forces during a bull market, a cash position represents an actual speculation on the bear forces during a bear market. The long-term job for the average investor from here on will be to try to control the natural human tendency towards greed, to avoid psychological pitfalls, and to keep his cash assets generally safe and intact.

The Composite Chart (Page 1) shows the two leading Industrial Averages retracing better than 33% of their May-June loss in a matter of four trading days (the rapidity of the correction is typical of bear market rallies). The position of the A-D ratio suggests that a great mass of stocks on the N.Y.S.E. are still near their lows for the year. Selling pressure has eased but is still dominant as seen by the 10-day average of advances and declines (black area). Odd-lotters are reacting normally by buying the rebound following a drastic decline, but odd-lot shorts have come in strongly as seen by the ratio. One of the most surprising developments is that only 23% of the 432 stocks (which we follow) are now holding above their 200-day moving averages. This is a new low for this important indicator. The Eurosyndicat Index has dropped to 129, lowest point of the past few years. Almost all of the world's markets are at or near lows. This situation can bring about the following ominous type of development: (from U.S. News — July 5) " Large American and European banks, with huge loans outstanding in Japan, are sending their best analytical brains to Japan for a closer look." (My comment: "better late than never.") The London Financial Times Average has broken the critical 320 level, and thus reconfirms the major bear market which started in Britain in late 1964. For the edification of subscribers at this critical stage, I have shown

OTHER SERVICES: The July issue of the famous Bolton-Tremblay Bank Credit Analyst (see last Letter) offers little fodder for the bulls. One of Bolton's most important indicators, the debit-loan ratio has now gathered momentum on the downside. Bolton treats the whole U. S. much as a neighborhood store. When sales (debits) are high while borrowing (loans) is low, all is healthy. As sales increase the store increases its borrowing and this too is fine. Finally, loans continue to push up while sales drop off. This is where the trouble starts, and this is where the U. S. is now. Commercial industrial loans in the U. S. have skyrocketed during 1965, while the latest (May) figures show debits 5.6% under April and only 6.2% above May, 1964.

Writes Bolton: "History shows that it is impossible for any length of time to increase loans at a much faster pace than spending without creating the environment later whereby the spender has to cut back on his (rate of) spending in order to reduce bank loans." Other quotes from Bolton: "The disconcerting part of the present bank credit environment is that it seems to be developing downward momentum sharply in the last few months." "... Enough has been said to indicate that on the basis of past experience, a highly cautious investment policy should be followed. The development of so rapid a deterioration while not at all unique nevertheless leaves us with no alternative but to consider the overall situation as unfavorable."

profiles of world stock exchanges on the chart at right (courtesy of my friends at Securities Analysts Ltd., 50 Denmark Hill, London S. E. 5). Conclusion: short term indicators such as odd-lots point to the possibility of a further retracement towards the highs for the U.S. market, but the long-term picture suggests that investors prepare for major trouble before the summer is out.



STOCKS: I have received so many letters from subscribers over the past week or so that I have been unable to answer them all and still do justice to Dow Theory Letters. I ask subscribers to excuse me, but I do try to answer questions of broad interest in these Letters. The following imaginary "conversation" may answer some of the questions regarding "discounted puts":

Customer to Broker: Jim see if you can get me quotes based on current market prices for one year put options on the following stocks, Chrysler, Deere, Trans World Airlines.

Broker (calling back after a few hours): Chet, here's what I got. They want $600 for a one year put on Chrysler at today's price of 44. They want $500 for Trans World at today's 43. No quotes at all for Deere.

Customer: O. K. Now, go back and tell them I'll offer, oh let's see, $300 for Chrysler at 39. I'll give them 5 points on that. And I'll offer $250 for Trans World at 39. I'll concede 5 points on that one too.

Broker: That means that Chrysler has to drop below 36 within the next year before you make money and Trans World has to go under 35½ before you make money there, right?

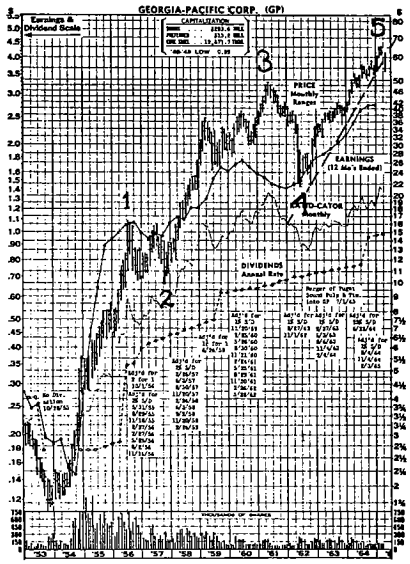
Customer: Correct. But I'm betting that the top will come and that the bear market will be in "high gear" within the next year, Jim. So see what you can do on these.

Broker (a few hours later): Chet, they offered Chrysler at 39 for one year at $325; Trans World for a year at $350.

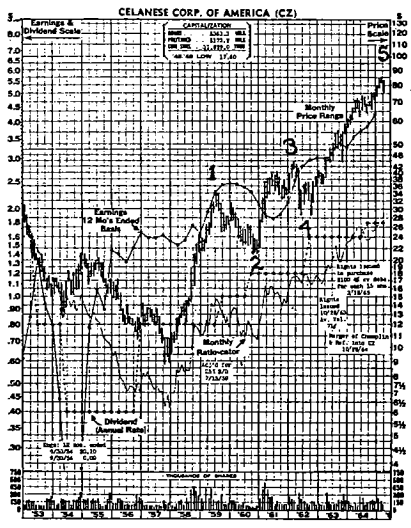
Customer: I'll take the Chrysler. Let's wait a while on the other. If this market rally keeps going for a few more weeks I think it will be easier to buy puts at a price. There's still a little too much bearishness around now.

What criteria does one use in selecting stocks for put options? Any number of measurements may be used including relative strength (see last Letter), price-earnings ratios, currently weak industry groups, cyclical groups based on past history — such as copper or machine tools, etc.

One method which interests me is based on price structure. It was R. N. Elliot who noted that many primary movements occur in five legs (three up and two down), many corrective movements occur in three legs (two down and one up). While there are exceptions to this observation, the fact remains that it occurs so often that it cannot be dismissed. In my own experience, I have found the "five leg primary movement" thesis to be a valuable tool. When a stock has completed five legs (particularly when those legs can be identified on a monthly or long term chart) it is a hint that the major movement in that stock "may be" over. This type of reasoning is particularly valid when the general market also appears to be nearing the end of a major movement.



I have included monthly charts of two stocks, Georgia Pacific (GP) and Celanese (CZ) to illustrate my point. GP started its bull market in 1953. The fifth (often the speculative) leg for GP started in 1962. It is almost axiomatic relative strength will be impressive on the fifth leg of a stock's bull market. The trendline for the 5th leg of GP was broken this month, and it is possible that the bull market for GP is now nearing an end. It is not unusual in a bear market for a stock to cancel out its entire 5th leg. If GP were to return to point 4, it would lose far more than half its current value. Much the same may be said of CZ, a stock which almost tripled in price on its 5th speculative leg. Both of these stocks should be interesting candidates for discounted puts. A discounted put on GP at 49 sounds low, but as seen on the chart, 49 is actually in the vicinity of GP's top. A put at 69 for CZ would also be near that stock's high as seen on the chart.



The following stocks are all on the 5th leg of bull markets and still "on their highs." As such they are interesting candidates for discounted put options. These stocks are: ABC Paramount, Armstrong Cork, Assoc. Dry Goods, Federated Dept. Stores, Northwest Airlines, Rexall Drugs, Sears Roebuck, FMC Corp., Pan Amer. World Airways, Xerox.

Late Note: (written Tuesday, July 6, at noon). Don Worden ("Worden Tape Reading Reports") notes a definite preponderance of "big blocks" on the downside during last week's rally. Heavy distribution by large interests is underway, and if this is true it will be up to the public to carry the ball from here.

Charts of CZ and GP courtesy of Securities Research Corp., 211 Congress Street, Boston, Mass.